<u>CHINA: CURRENCIES, COMMODITIES, AND US TREASURIES</u>

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In Frank Norris's novel, "The Octopus" (published in 1901), Cedarquist declares: "Our century is about done. The great word of this nineteenth century has been Production. The great word of the twentieth century will be…Markets."

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Thanksgiving beckons. Most American travelers surely prefer joyful holiday festivities to financial marketplace firestorms. Besides, there have been ample courses of trouble, anxiety, and heartache since the worldwide economic crisis erupted, enough to last for several seasons. Yet Thanksgiving rests a few days away. And since not all nations celebrate America's Thanksgiving, and given China's increasing economic intertwining with America, why not briefly discourse about China in the context of currency, commodity, and interest rate marketplaces?

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Let's present the dollar's woeful decline as the first menu item. The broad real trade weighted United States dollar recently challenged its all-time lows, reaching about 84.5 for October 2010. The October 2010 dollar depth is only slightly above the dismal basements of October 1978 (84.1), July 1995 (just over 84.0), and April 2008 (84.3). Not only is that quite a tumble from a March 2009 top at 97.1 (around the time of equity price troughs). Especially in the wake of the Federal Reserve's further expedition into quantitative easing, both the low level and substantial depreciation from June 2010 to October (about 6.3pc) partly account for the recent loud squawking regarding the dollar and related issues by numerous marketplace regulators and players.

America still wants China to revalue its currency, the renminbi, more substantially and rapidly. But might such further Chinese revaluation, with the trade weighted dollar sitting near historic lows, risk a dollar crisis?

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In both the current and long run dollar trend contexts, with the dollar currently close to falling off the table, it's worth remembering a little-noticed speech by China's Central Bank Governor from about 18 months ago ("Reform the International Monetary System"; on or around 3/23/09). It comments regarding the need for "creative reform of the existing international monetary system toward an international reserve currency with a stable value" such as the International Monetary Fund's Special Drawing Rights (SDR).

"The scope of using the SDR should be broadened, so as to enable it to fully satisfy the member countries' demand for a reserve currency". This should involve (emphasis supplied): "**Actively promote the use of the SDR** in international trade, **commodities pricing**, investment, and corporate book-keeping."

Underline the Governor's almost explicit approval of commodities as a potential eventual element of this monetary structure. "Back in the 1940's, Keynes had already proposed to introduce an international currency unit named "Bancor", based on the value of 30 representative commodities. Unfortunately, the proposal was not accepted. The collapse of the Bretton Woods system…indicates that the Keynesian approach may have been more farsighted." **Whether the Governor currently approves of a super-sovereign currency**

involving commodities is not completely clear, but he may. "The reestablishment of a new and widely accepted reserve currency with a stable valuation benchmark may take a long time. The creation of an international currency unit, based on the Keynesian proposal, is a bold initiative that requires extraordinary political vision and courage."

Here is the link to his speech:
http://www.pbc.gov.cn/publish/english/956/2009/20091229104425550619706/20091229104425550619706_.html

The Governor's commodity remarks are noteworthy, particularly given China's sustained efforts to stuff its cupboards with inventory of and assets related to a number of commodities. The economic and strategic importance of China's commodity related acquisitions thus arguably reflect more than an understandable battle to "keep the economic wheels running by having enough around (ensuring supply)." Taking a long run vision, that policy also represents a quest to own and have influence over commodities as a store (reserve) of value.

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Nevertheless, suppose the SDR does not grow significantly in popularity or practical use. Some oracles imagine a role for gold may emerge. Anyway, suppose commodities in general do not become part of a new currency order anytime soon.

The increasing global use of China's currency will enhance its role in any eventual new monetary structure. China has signed currency swap agreements with seven countries. China will permit foreign central banks and overseas lenders to increase investment in its domestic interbank bond marketplace (Financial Times, 8/18/10, p2). **China's ongoing promotion of its currency, the renminbi, reflects China's growing international economic and political importance and some relative erosion of the dollar.**

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Here's an interesting statement of recent vintage from a Bank of China Deputy Governor: "Exchange Rate Regime Reform and Monetary Policy Effectiveness" (7/26/10). Note the four objectives of monetary policy- "price stability, growth, full employment, and balanced BOP [balance of payments] account". He declares: "Exchange rate policy has played a role in achieving these macroeconomic objectives." Compare the Federal Reserve's muddy rhetoric on exchange rates.
http://www.pbc.gov.cn/publish/english/956/2010/20100804100116452770088/20100804100116452770088_.html

China is quite aware of the entangling of economic growth, political stability, and social considerations. China's concern about substantial and rapid renminbi revaluation relate to fears regarding resulting potential economic and social disturbance. For example, see the comments by Wen Jiabao, China's premier (Financial Times, 10/7/10, p1).

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Let's view China's currency concerns and policies and dollar trends from the perspective of official foreign exchange reserves. The International Monetary Fund's COFER (Currency Composition of Official Foreign Exchange Reserves) tables display the holdings in arithmetic terms (in millions of US dollars) by advanced and emerging/developing economies back to 1995. COFER reserves consist of monetary authorities' claims on nonresidents in the form of foreign banknotes, bank deposits, treasury bills, short and long term government securities, and other claims usable to satisfy balance of payments requirements. As COFER data is reported in US dollar terms, foreign exchange fluctuations presumably affect the reported dollar levels of claims not denominated in dollars.

Although COFER statistics do not reveal individual countries, they offer insight into worldwide attitudes and appetites regarding the dollar and dollar-denominated assets. Focus on the allocated reserve holding category. The reserve totals for both advanced economies and emerging/developing ones have steadily increased in arithmetic terms over the years. However, suppose one looks at the claims in US dollars as a percentage of allocated reserves. Then review these percentage holding levels of dollar claims in the context of US dollar trends.

The broad real trade weighted US dollar peaked in first quarter 2002 (February, around 113.0). The summit of US dollar holdings in percentage terms for all countries combined likewise was achieved in 1Q02, at 71.6 percent. Advanced economies held 70.5pc of their reserves in dollars that quarter, with emerging/developing countries at 74.2pc (in 1998 developing nations grasped 75.5pc in dollars). **By first quarter 2010, all countries combined dollar reserves equaled 61.7pc. Advanced nations cut their holdings to 65.0pc. Those on the plates of emerging/developing nations dwindled dramatically in percentage terms, to 58.0pc**. Second quarter 2010 evidenced little change; all was 62.1pc, advanced 65.2pc, and developing 58.4pc.

Emerging/developing nations (presumably including China) hold an increasingly hefty share of the COFER reserves. Although these statistics do not unveil what an individual country is doing, the sharp reduction in percentage dollar holdings by the clan of developing nations opens a particularly interesting window on their "overall" attitudes toward the dollar. Think of the various dollar-related comments by key Chinese officials in this context.

Does the further weakness in the dollar since 2Q10 reflect further diversification away from the dollar, whether in official reserves or elsewhere (or both)? Might many nations and other owners of dollar denominated assets be very disgruntled if the dollar depreciated even further alongside a fairly sharp (and rapid) jump in US Treasury yields?

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Lamentable fiscal deficits in Europe, America, and elsewhere haunt international financial guardians and politicians. Budget deficits and interest rate securities holdings are not separated from currency levels and trends. Picture the American scene with a focus on US Treasury securities and China.

The US Treasury estimates holdings of US Treasury securities by individual nation (TIC data). China's ("Mainland") ownership of US Treasury securities has not increased over the past year. Actually, it has slipped. In October 2009 they were $938.3 billion. In June 2010 they were $843.7bb. The $883.5bb in September 2010 is still 5.8pc thinner than that of October 2009. Mixing in Hong Kong does not change the view. Its holdings were about $138 billion in October 2009, with September 2010 at $136bb. This TIC data on US Treasuries combines official and private holdings, so one cannot definitively identify official Chinese policy. **However (and especially in light of the COFER statistics), reduced net buying (and of course net selling) by China of US government debt hints at their effort to diversify reserve holdings from the dollar.** This shift may only be in percentage terms rather than in total arithmetic holdings. Yet it still is a bearish sign for the dollar.

Since America continues to issue more and more debt, sustained patterns of reduced net Chinese buying (and of course net selling) of US Treasury securities is a bearish factor for US government note and bond prices. And quite unsettling for those worthy financial watchdogs who yearn to keep US interest rate levels low! **What if other nations behave the same as China? In any event, perhaps other foreign sources or Americans will replace Chinese demand.**

But perhaps the Federal Reserve will be the key incremental American buyer of such US debt securities via its beloved quantitative easing (monetary printing) extravaganza. The Fed clearly is willing to gobble up US government notes and bonds. And who knows, the Fed may even renew its taste for mortgage-backed securities.

What consequences may this Fed money printing policy have for the US dollar? Suppose the US makes no significant progress on slashing its deficits. What happens if foreigners in general become substantial net sellers of US interest rate securities? What happens for major equity playgrounds if yields rise substantially alongside a further noteworthy slump in the dollar?

The TIC report does not break down net foreign purchases of long term agency and corporate bonds by nation. However, these also should be watched in regard to interest rate and currency trends. In September 2010, foreign official institutions were net sellers of agencies, spitting out over $31 billion of them.

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Chinese consumer price inflation has increased, reaching 4.4pc year-on-year in October 2010, above the government's three pc target. China's large and escalating world economic influence is well-known. Don't higher Chinese interest rates due to its inflation concerns (or worries about too easy domestic credit conditions) boost potential for higher yields in many other corners of the rest of the world, particularly given the Fed's recent additional quantitative easing? After all, though the Fed scheme involves note and bond buying, it also clearly seeks to increase inflation.